

The increase in defense spending swelled an already strongly rising tide of business investment expenditures. From the second quarter of 1965 to the first quarter of 1966, business spending for new structures and equipment rose by \$9 billion. Defense, investment, and social security liberalization, in combination, speeded the growth of disposable income. Consumer spending responded strongly, growing by \$29 billion over this three-quarter interval. All in all, GNP advanced at an average of \$16 billion a quarter. Real output grew at a phenomenal annual rate of 7.2 percent, and industrial production rose at an annual rate of 9.7 percent.

Unemployment fell from 4.7 to 3.8 percent of the civilian labor force during this period. New orders for durable manufactured goods rose markedly by (12 percent), with orders for electrical machinery (20 percent) and defense products (19 percent) increasing especially rapidly.

The surge in demand for goods and labor created pressures on prices in many areas. From October 1965 to July 1966, the annual rate of advance for industrial wholesale prices stepped-up to 3 percent. Prices of industrial crude materials moved sharply upward—at an annual rate of 8 percent from October to April. At the consumer level, demand pressures raised prices of services and nonfood commodities and combined with special supply factors in agriculture to push up food prices. These price movements and their consequences are discussed in detail in chapter 2. All in all, the economy exceeded reasonable speed limits in the period from mid-1965 through the first quarter of 1966.

MODERATION IN THE PACE OF ADVANCE

After years of providing stimulus to the economy, policy changed direction at the turn of the year. Monetary policy accounted for a major share of the restraint during most of 1966. As described in detail below, the Federal Reserve restrained the growth of credit supply in the face of extremely strong demands for borrowing by business. With intense competition for funds, interest rates rose sharply. Institutions which supply mortgage funds to the home-building industry lost deposits both to the commercial banks and to the market for new corporate securities. As a result, residential construction was starved for funds, and the sharp decline in this sector was one of the principal moderating influences during the second half of 1966.

Fiscal policy also responded effectively. Although the special defense costs necessarily swelled Federal outlays and were highly stimulative, restrictive actions were taken in other areas. Increases in nondefense purchases were held to \$300 million from 1965 to 1966. Several restrictive tax measures were proposed in January 1966, and were enacted in mid-March. These included a reinstatement of some of the earlier excise tax reduction, restoring about \$1 billion to the annual rate of Federal revenues; and a system of graduated withholding for individual income taxes that drew off \$1½ billion (annual rate) from disposable income beginning in May. These new measures followed the \$6 billion increase in payroll taxes that took effect at the start of 1966. In addition, revenues were increased in the spring by unusually large payments on 1965 income tax liabilities.